

Ofgem
10 South Colonnade
Canary Wharf
London
E14 4PU

11 November 2024

Call for Input: Energy Networks Ring Fence Review

Dear Sir/Madam,

Further to Ofgem's Call for Input dated 18 September 2024, we have laid out the position of National Gas Transmission below.

1. Have we identified the issues and challenges network companies are facing accurately? (Yes/No)

We consider that the Call for Input takes a simplistic approach in identifying issues and challenges and do not consider that the case for additional restrictions to the ring-fencing provisions in the licence has been properly made out at this stage. In the "Context" section of the Call for Input, Ofgem introduces three main risk areas considered the factors driving the need to review ringfencing arrangements: changes in corporate structure (characterised as the move from ownership of regulated activities by listed entities to private equity/large conglomerates), "financial engineering" (primarily characterised as the introduction of intermediate companies above the licensee) and challenges in other sectors (primarily characterised as the financial difficulties suffered by Thames Water).

Whilst these matters may be relevant to the assessment of the effectiveness of ring fencing provisions and the existence of changes in ownership structures and difficulties faced in other sectors is not disputed, there are other relevant factors in assessing the impact of such matters which Ofgem should consider in its review of the effectiveness of the ring-fencing requirements:

- Financing policies and strategies are already constrained by characteristics of the regulatory ringfence (for example, regulatory gearing, separation of activities etc) regardless of the ownership structure. Ofgem has already enhanced these via new requirements introduced for the FY24 reporting cycle (which focused on further disclosures) and in T3 proposals captured in SSMD (which includes dividend lock up requirement and the requirement to maintain more than one credit rating)

- We would urge Ofgem to carefully consider the threats it is seeking to address and the sufficiency of its evidence to say that certain financing structures are inherently risky and have the potential to cause consumer harm. We do not consider that this call for input has provided sufficient evidence to demonstrate this and we note that many of these structures create benefits to consumers in terms of better ratings and the consequent lower cost of debt. Plc structures with listed equity, particularly those that operate multiple businesses, are not in many cases materially different to “Midco” and “Holdco” structures given the presence of debt financing arrangements, cash pooling arrangements etc. in entities above the regulated business(es). We would be happy to review such evidence and provide further feedback as appropriate.
- The financial resilience of the sector to date is recognised by Ofgem: within SSMC (December 2023) Ofgem itself states that financial resilience requirements “have been broadly effective in helping shareholders and management to maintain financial policies and outcomes that are consistent with a financially resilient sector”. NGT takes its responsibilities in this regard seriously and has complied with these requirements during the RIIO-2 period. Networks have faced many challenges over RIIO-2 and with the suite of tools and reporting that Ofgem has available to it to monitor the financial resilience of network companies, NGT feel Ofgem has already captured the challenges and enhanced resilience reporting during RIIO-2 to a satisfactory level.

2. Are there any other issues that may pose a threat to the regulatory ring fence that we should consider?

Ofgem notes both in SSMD and the Call for Input that the primary responsibility for financing strategies and resilience lies with the networks. As such, networks are responsible for setting their own financing strategies within regulation guidelines, with the objective of raising capital efficiently being aligned to consumer interests. There could be a threat that further restrictions on financing strategies through either ring fencing requirements or other restrictions may undermine this principle and contribute to higher costs.

Our stakeholder engagement throughout the compilation of our RIIO-3 business plan demonstrates that regulatory certainty and consistency are key factors in maintaining an investment grade and defining the return investors are willing to accept for their investment. Indeed, many investment decisions have been made based on the current rules. Inappropriate restrictions may therefore reduce investor confidence and impact on investors’ willingness to invest, which may ultimately lead to higher financing costs and subsequently higher consumer bills.

We do not consider that there are issues around the regulatory ring fence at present more generally and the existing protections are sufficient for the sector. As summarised in our response to question 5, considerable strain was placed on networks during the current price control period through significant price shocks and changes in network use, but these were effectively mitigated by existing requirements and facilities we already have in place.

3. Are there any weaknesses within the current ring fence conditions that we should consider?

Ofgem itself lists the proposed amendments to the financial resilience requirements already laid out in SSMD. As noted in its response to the SSMC, NGT does not object to these additional requirements and noted that they appear to reach an appropriate balance between providing networks and the regulator with further insight and forewarning of potential issues without undermining key regulatory principles.

NGT believes that this process could provide an opportunity to refine known issues both now and in the future and identify likely impacts/conduct cost benefit analysis for any proposed changes. Where there are inconsistencies in the obligations placed on licensees (for example as Ofgem has identified the lack of a requirement for an ED network to provide enhanced reporting in the event of a rating downgrade) these should be aligned, as there appears to be no valid distinction between the sectors that would drive such an inconsistency. The same applies to obligations that are open to interpretation, which again can lead to inconsistencies between networks/sectors. Accordingly, adequate guidance to ensure everyone is held to the same standard of compliance is essential.

NGT also submitted in response to SSMC that the opportunity to repurpose assets on the network for future uses/businesses (for example, hydrogen or CCUS) presents a significant opportunity to avoid asset stranding or decommissioning costs for consumers and to facilitate the transition to net zero at a lower cost. We continue to engage with both DESNZ and Ofgem to share our work and proposals on how such mechanisms should operate, particularly in respect of deriving a value for assets to be transferred and defining how a disposal process should operate at this scale. An asset transfer value mechanism is not currently defined and the existing disposals process is not fit for such purposes. As such, this Call for Input and our related engagements with Ofgem and DESNZ should be an opportunity to address these matters.

4. Which would be your preferred option of the three outlined and why?

As we submitted in our response to SSMC, we consider the additional requirements already proposed or implemented by Ofgem to be sufficient. As such, for the sectors subject to the current RIIO-3 price control assessment (i.e. GT, ET and GDNs), Option 1 is appropriate. Introducing further restrictions may strain investor confidence when an appropriate balance of scrutiny and network choice of financing strategy has already been reached. However, given the further matters that should be addressed that we note above, NGT is open to further discussions on Option 3 (Detailed review), allowing Ofgem to address such specific matters. We do not support option 2, being a more interventionist regime, given the potential consequences outlined above for customers and stakeholders (notably the risk of higher costs) and the learnings from what is happening in other sectors with more interventionist ring-fencing regimes.

5. What are your views on the three options outlined and the associated benefits and risks of each?

As noted above, NGT stated at SSMC that the existing requirements, coupled with the enhancements Ofgem has made for the FY24 reporting cycle and proposed in SSMD for RIIO-3, strike an appropriate balance between enhancing Ofgem's insight of potential issues whilst maintaining the principle that networks should take responsibility for their financing strategies within the parameters set by the regulator. Within these parameters, networks therefore have the incentive to attract capital at an efficient cost, which is consistent with consumer benefit.

As such, option 2 does not seem appropriate as it potentially introduces restrictions not justified by the manner in which the sector has dealt with recent turmoil in the financial markets. In contrast to the retail sector, where energy price shocks in particular exposed the lack of financial resilience in that sector, network companies have dealt with these issues and maintained credit ratings and operated within the regulatory parameters. To that end, a requirement to hold reserve facilities would not seem consistent with the risks experienced by the sector and if introduced, would lead to additional borrowing costs for networks ultimately leading to increased costs to consumers. We do however separately note that NGT already maintains significant short-term cash facilities to ensure it can meet its regulatory obligations (shrinkage costs, network balancing, supplier of last resort etc) and these provided more than adequate coverage to manage the unprecedented price shocks and the change in the use of our network that followed the Russian invasion of Ukraine in 2022.

Additional restrictions of activity increases the risk of interfering with the principle of network choice of financing strategy. We also note securitisation of the regulatory asset base is already restricted and not a realistic option for networks. It is therefore not clear how "specific risky" activities would be defined or would add to consumer protection. Notably, there appears no clear difference between listed groups and private groups in the use of entities above a regulated operating company to facilitate debt raising.

With respect to financing structures above the regulated entity, in NGT's view restrictions already in place such as regulatory gearing (with the associated cash clawback) and dividend lock ups, requirements to maintain investment grade ratings etc already protect regulated entities, restrictions on which NGT's financial policies are based. We support these restrictions and note the contrast with other regulated sectors where issues have been experienced (higher gearing in the water sector for example).

Closer scrutiny of ownership structures appears consistent with reporting requirements already implemented for the FY24 reporting cycle save for the expansion to requiring the disclosure of all investors rather than just those with a controlling interest, where we have concerns. Given the impracticalities of this – investment funds have a significant number of investors, often via other investment funds, an impracticality that is equally valid for listed entities, where shareholders can change daily and shares are also held via multiple investment funds, where shareholders may also change frequently – it is not clear what additional consumer interest would be served by such a measure given the absence of controlling interest and consequent lack of influence

over the operations of the regulated company. Should any such requirements be implemented, listed and unlisted entities should be treated equally.

As seen in the acquisition process for National Gas, there is significant scrutiny of new controlling interests and significant shareholders via approval processes not only administered by Ofgem but also Government departments, which would appear to address this public interest risk. The identities of direct shareholders in regulated companies are also already publicly available.

For the networks subject to the RII0-3 price control, we believe Option 1 is the most appropriate choice. NGT is however, open to considering option 3, consisting of a targeted review of existing requirements. We would ask that this be focussed on the asset transfer process and the requirement to address inconsistencies with networks not subject to the RII0-3 regime (i.e. electricity distribution networks). Any changes proposed should be proportionate and equitable, notably on the matter of corporate structures.

6. Tell us if you have suggestions on how we can improve our proposed options.

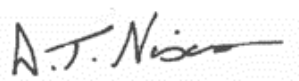
NGT would be willing to work with Ofgem regarding these questions and issues. To help improve the options NGT believe that working more closely with Ofgem on a process to establish an asset transfer value and disposals process will help resolve some of the matters Ofgem has raised in the call for input.

7. Tell us about any alternate options we should consider.

Not applicable.

We look forward to further engagement with you on the specific items laid out in our question responses.

Yours faithfully,



Tony Nixon
Regulation Director